Cabinet Office

Scaling Community Lenders

The Role of Social Investment

January 2015

Contents

Foreword from the Minister for Government Policy

All too often, people find themselves with an urgent need for cash. Getting the money within a few days, or even a few hours, can be vital.

We all know the perils of the Payday lending market that has developed to meet this need. Even with the present Government's measures to cap Payday lending interest rates, many families can't afford to borrow from these lenders and quickly get into trouble if they do so.

This is where community lenders come in – offering a way of saving and borrowing that is human in scale; emotionally intelligent, and fast to act in emergencies.

The more we extend the scope of community lending, the more we can meet these acute social needs, at interest rates that people on low incomes can manage and, at the same time, community lenders can build up habits of saving which help people to put away money for a rainy day.

For all of these reasons, the Government wants to see community lending grow – and eventually play a role on the scale we see in some other countries such as the US, where credit unions are the norm for tens of millions of employees in countless firms.

At present, in the UK, we are still way short of where we need to be as far as community lending is concerned. Our community lenders are unable to meet the demand for credit.

To address this shortfall, many community lenders are aiming to scale up their services by raising capital. But they often hit problems when they do seek new capital, because their low margins, relatively small scale and short track records make it difficult for purely commercial investors to justify the investment.

This report suggests that social investment could have an important role to play in filling the financing gap. Drawing on discussions with over 100 sector experts, the analysis highlights how social investment could be used to meet the capital demands of community lenders at different stages of growth and help organisations leverage mainstream sources of capital.

I welcome this much needed analysis, and I hope it will help to persuade social investors to participate, so that we can build a far larger community lending market in the UK.

The Rt Hon Oliver Letwin MP

Introduction

The social investment market is growing, with demand expected to reach £1bn by 2016[1]. As the market matures, so too does our understanding of how social investment can be used to support different types of social venture to tackle challenging and often entrenched social issues.

A particular area of focus within the social investment market has been the issue of financial inclusion and more specifically, the potential for community lenders, including community development finance institutions (CDFIs) and credit unions, to scale up their personal lending activities to offer people on low incomes more affordable alternatives to the products provided by the high cost credit industry.

The community lending sector is diverse, with over 400 credit unions, about a dozen personal lending CDFIs and a small number of other lenders, including housing associations.These lenders vary significantly in a number of areas including the size of their loan book, customer base and business strategy. To understand more about the potential role of social investment in this sector, we identified a smaller number of organisations that have demonstrated a commitment to sustainability, invested in their management and back office structures, and built up a track record of taking on investment. This report focuses on these organisations and explores three hypotheses:

1. Community lenders have limited access to the capital they require to scale

2. Community lenders have immediate demand for investment

3. Social investment can play a role in meeting some of this demand

To test these hypotheses, we surveyed 20 community lenders and spoke to over 100 sector experts from social and mainstream investors, social investment finance intermediaries (SIFIs), think tanks, debt advice organisations and across government. These discussions introduced a range of different perspectives which helped to build an understanding of the sector and the potential role of social investment. This report presents the findings of these discussions and suggests that there is a range of ways that social investment could be utilised to meet the capital needs of community lenders as they scale up their provision of affordable finance to people on low incomes.

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1 Brown, A. and Swersky, A (2012) *The First Billion: A Forecast of Social Investment Demand*. The Boston Consulting Group and Big Society Capital.

Context

Community lenders are not-for-profit organisations, such as credit unions and CDFIs, which provide financial services including loans and savings. The personal loans that community lenders provide are often targeted at people with limited access to mainstream sources of credit such as bank loans, overdrafts or credit cards. Many of these customers are on low or irregular incomes and loans enable them to manage the peaks and troughs in income by smoothing their cash flow.

A study of the personal loans provided by CDFIs revealed that 29% were used to pay for one-off needs, 26% for basic bill payments, 14% to consolidate other loans and 11% to buy household goods and cover maintenance costs[2]. Loans therefore enable people to manage their finances in the face of persistently low or insecure income.

In addition to the provision of personal loans, community lenders also use their interactions with customers to identify and help address wider causes of financial difficulties through advice and education services. Part of this work involves supporting customers to develop saving behaviours which can help to insulate them from future financial shocks and promote financial inclusion.

Places for People

With 148,000 homes under ownership or management, Places for People is one of the largest housing associations in the UK. Places for People Financial Services is a subsidiary which was initially set up to offer tenants affordable loans and counter the negative influence of high cost doorstep lenders.

As a landlord, Places for People, has observed that high cost loans often lead to tenants experiencing difficulties in being able to meet essential payments such as rent, mortgage, food and utility bills. In response to increased concern about the uptake of high cost credit, including Payday loans, the organisation has now committed to significantly scaling up its personal lending capacity and plans to offer affordable loans to new customers beyond its tenant base. Places for People has already begun investing in improving its lending infrastructure and as it scales-up operations it is seeking social investment to help grow its loan book.

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[2] CDFA (2013) *Inside Community Finance: The CDFI Industry in the UK*. Available at: http://www.cdfa.org.uk/wp-content/uploads/2010/02/ICF-2013.pdf, retrieved 01/08/2014, p.42.

Although community lenders provide a valuable service to people on low incomes, they are currently unable to meet the consumer demand for £3bn-£3.5bn credit per year[3], with lenders and membership bodies pointing to the lack of appropriate capital as the major obstacle to bridging this gap. In the 2012-2013 financial year, credit unions and CDFIs made approximately £719m of personal loans[4], which can be contrasted to a high cost credit market which is believed to provide around £7.5bn of loans per year[5]. Almost £3bn of this lending was met by the Payday loan industry, which has tripled in size since 2007, largely due to the growth of online services[6]. Online Payday lending companies compete on the basis of ease and speed of transaction, rather than price, with companies offering a turnaround time of just ten minutes for loans which, prior to the introduction of the price cap[7], had Annual Percentage Rates (APRs) often in excess of 2,000%. Whilst many customers choose these services for their ease of access and perceived flexibility, others do so because of a lack of accessible alternatives.

The social impact of consumer credit switches from positive to negative if debt turns into over-indebtedness on a structural basis. In contrast to loans from community lenders, high cost loans tend to lead to increased difficulty in paying expenses. Customers of high cost credit providers have reported finding themselves in a 'debt trap' where debt levels rise unmanageably as loans are continually renewed and consolidated. In such a situation, borrowers may only be able to afford minimum interest payments rather than paying back the principal amount[8].

The high cost credit market, and the lending practices of the Payday industry in particular, has come under considerably scrutiny from the Financial Conduct Authority (FCA), Office of Fair Trading (OFT) and Competition Commission (CC)[9]. The FCA has implemented a range of regulatory measures to curb some of the most concerning practices; however the demand for credit amongst low-income households is likely to remain. The challenge for community lenders is whether they can scale up their provision and respond to the increased market demand for flexible products available at short notice.

3 CDFA (2012) *Inside Community Finance: The CDFI Industry in the UK*. Available at: http://www.cdfa.org.uk/wp-content/uploads/2010/02/CDFIs-in-the-UK-report-web.pdf, retrieved 01/08/2014, p.7.

4 CDFIs lent £19m (CDFA (2013) *Inside Community Finance: The CDFI industry in the UK*, p.4) and credit unions lent just over £700m to members, (Bank of England (2014) *Credit Union Annual Statistics – 2013*, p.4). It should be noted that Northern Irish credit unions accounted for over 38% of the total amount loaned by credit unions in the UK, reflecting the relative strength of the credit union movement in Northern Ireland.

5 OFT (2010) *Review of High-Cost Credit: Final Report*, p.4.

6 In 2012/13 the industry was valued at £2.8bn (CMA (2014) *Payday Lending Market Investigation: Provisional Findings Report*, p.3) compared to a valuation of £0.9bn in 2008/09 (Edmond, T. (2014) 'Payday Loans: Regulatory Reform', *Standard Note: SN/BTS/6676*, London: House of Commons Library, p.2)

7 The Financial Conduct Authority (FCA) introduced a cap on the price of Payday loans from 2 January 2015.

8 Harris, B. J., Treanor, M. & Sharma, N. (2009) '*Below the Breadline*', *Report from Barnardo's Research and Policy Unit*. Available at: http://www.barnardos.org.uk/below_the_breadline.pdf, retrieved 01/08/14, p.63.

9 The Competitions and Markets Authority took over many of the functions of the OFT and CC on 1 April 2014.

Access to capital

In order to scale, community lenders require access to capital for a range of purposes including onward lending and to develop their business. Many of the community lenders that we spoke to expressed an appetite to take on investment, however they had found it difficult to secure the level and type of funds that they require. In particular, a number of community lenders raised concerns about the lack of access to long-term sources of capital that would enable them to develop sustainable business growth strategies.

Over the last five years, the community lenders surveyed had raised over £13m of investment at rates of up to 10%. More than 20 different investors had provided capital, including mainstream and social banks, trust and foundations, social investment funds, housing associations and high net worth individuals. This investment had helped organisations meet their immediate operating costs but had largely failed to address the demand for growth capital.

Our discussions with community lenders, investors and intermediaries highlighted three contributing factors that are restricting wider access to capital: community lenders' limited track record of taking on and repaying investment; varying investor confidence in the operating model; and a lack of clear articulation of the social impact of providing consumption loans to the target market.

Track record

Credit unions and CDFIs have both received substantial government funding over recent years[10]. Over the last five years, the organisations that we surveyed had received more capital from grants than through investments. Some of this money was invested into improving their service delivery, however most lenders also used the grants to subsidise the cost of lending, passing on savings to existing customers in the form of lower APRs and widening access to loans for customers who may not otherwise have been eligible due to their risk profile.

As the amount of grant funding coming in to the sector has reduced, many organisations have shifted towards investment-based models. As they make this transition, one of the challenges they face is how to convince investors that, despite a limited track record, they can operate sustainably without the use of grant finance to reduce the price of loans.

[10] Government has invested £138million to strengthen credit unions through the Growth Fund and Credit Union Expansion Programme (CUEP). CDFIs have also received substantial funding over recent years, with a total of £72million invested through DTI's Phoenix Fund and the Regional Growth Fund.

Operating model

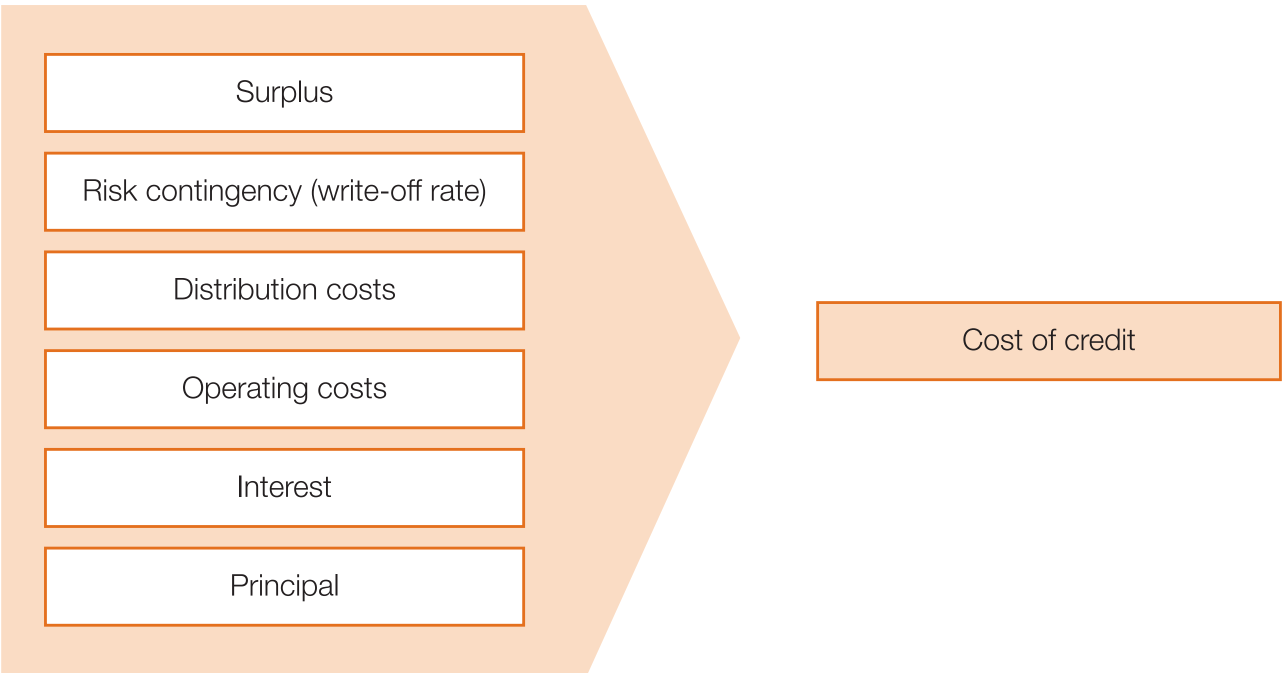
With less grant finance available, most lenders are now adjusting the price of their loans to reflect the true cost so that they can balance their books and lend sustainably (see figure 1).

The rise in the interest cap from 2% to 3% per month has provided some assistance to credit unions as they make this change. The absence of a cap on the rates that CDFIs charge means that they are able to operate sustainably whilst offering loans to higher risk customers than those served by credit unions. However, the need to price APRs anywhere from 40% to 100% has met with resistance from some governance teams and external parties.

Such rates are largely reflective of the cost of administering a high volume of small loans and also factor in the additional costs of providing coaching in financial literacy, which builds customers' capacity to service their debts. As CDFIs move to sustainable business models, there is an increasing recognition that they must cover their operating, distribution, capital and risk costs through interest and fees. The APRs charged by CDFIs enable them to operate in a market dominated by high cost providers. This is reflected in the FCA's latest regulations for the high cost credit industry, which exclude CDFIs, even if they are charging APRs of 100% or more[11].

Parallel to investor concerns about the price of loans, are questions regarding the write-off rates, which are often perceived to be prohibitively high. Write-off rates vary across the sector and the way in which grant finance was utilised by some lenders to widen their customer base has contributed to heightened levels of write-offs. However, many community lenders have a strong track record of effectively managing arrears and some of the most sustainable lenders have achieved write-off rates of less than 10%.

Figure 1: The cost of credit



[11] FCA (2014) *Detailed Rules for the FCA Regime for Consumer Credit, Including Feedback on FCA QCP 13/18 and 'Made Rules'*, Policy Statement PS14/3. Available at: http://www.fca.org.uk/static/documents/policy-statements/ps14-03.pdf, retrieved 01/08/2014, pp.142-143.

Social impact

For social investors, a further driver of the investment decision is the demonstrable social impact being created by the investee. In providing consumption loans, community lenders create social impact in terms of the positive behaviours they influence, e.g. financial education and savings, and the negatives and costly outcomes they prevent, e.g. eviction and job loss.

An examination of loan usage reveals that low income households use loans to smooth cash flow when unexpected expenses or decreases in income occur. On average, this happens six times a year and 93% of these unexpected events are considered temporary[12]. By providing affordable credit, financial advice and appropriate savings products, community lenders help to address immediate financial needs whilst working to improve financial literacy, increase savings and decrease over-indebtedness. Tackling these issues can lead to a number of positive social outcomes including better physical and mental health, improved family relationships, maintaining tenancies and remaining in employment.

Moneyline

Moneyline was established as a social lender in 2002. After an initial five-year period of grant support from the local authority, Moneyline continued its development by delivering a range of contractual grants through the DWP Growth Fund. Since 2012, Moneyline has moved away from grant dependent growth as it seeks to attract social investment to prepare for significant scaling of its model.

Planning to scale the business model whilst transitioning from grant dependency has presented a significant challenge. The grant subsidy created a significant and unrealistic gap between the price of the product to the customer and the cost of delivery. Moneyline has addressed this by:

- Increasing the price of the products to customers to reflect the cost of delivery
- Raising lending capital from social investors and including the cost and repayment of capital in the pricing model
- Raising grant finance alongside social investment to build the infrastructure required to scale

By using grant as development capital, rather than artificially subsidising the sustainability of the underlying business model, Moneyline has been able to strengthen its lending infrastructure and build its track record as a sustainable business.

[12] CMA (2014) *Payday Lending Market Investigation: Provisional Findings Report*. Available at: https://assets.digital.cabinet-office.gov.uk/media/539b1d16e5274a103100000a/PDL_PFs_main_report.pdf, retrieved 01/08/14, p.4.

Demand for investment

Our discussions with investors reflected different interpretations of the level of demand for investment amongst community lenders, with estimates ranging from £10m to £80m of demand over the next five years. To understand more about this demand we surveyed 20 community lenders, asking them about their plans for growth, including the amount of investment required and how they would utilise such capital.

Of the organisations surveyed, 14 expressed an interest in taking on investment, representing £33-£53million of investment demand over the next two years. The requirement for capital was split between loan capital for onward lending and development capital, to support infrastructure improvements and expansion. Discussions with the Department for Work and Pensions (DWP) and some of the credit unions also highlighted that as credit unions expand there may be future demand for regulatory capital.

Loan capital

To build their loan book, community lenders require capital to onward lend. The need for loan capital is most pronounced amongst CDFIs because, as non deposit-taking organisations, they are heavily reliant on income from loan repayments, which makes up around 68% of their earned income[13].

Credit unions present a different picture, as they are able to take deposits from their members. The balance between the amount of customer deposits and the demand for loans varies across credit unions and this has implications for their investment needs. Credit unions that have an employer based common bond can offer payroll deduction schemes to obtain regular deposits from their members, whilst those that have a geographic bond that contains affluent areas can offer saving products, such as ISAs, to boost customer deposits.

In contrast, credit unions with a geographic common bond located in deprived areas tend to have more members on low incomes, meaning that customer deposits can be insufficient to service the demand for loans. Investment can help these credit unions meet customer demand, however with the interest cap limiting the charges that can be applied to loans, only credit unions with efficient lending practices and effective arrears management can cover the cost of capital.

[13] CDFA (2013) *Inside Community Finance: The CDFI Industry in the UK*. Available at: http://www.cdfa.org.uk/wp-content/uploads/2010/02/ICF-2013.pdf, retrieved 01/08/2014, p.45.

Riverside Credit Union

Riverside Credit Union was established 25 years ago by the people of Speke, an economically deprived community on the outskirts of Liverpool. Riverside offers low interest loans and a safe savings facility in a location where there are no banks and where “predatory lenders” abound.

Riverside has historically managed to maintain sustainability via a combination of its trading activities and ability to attract external investment in the form of grants. However, reductions in the amount of grant finance available have now encouraged the organisation to seek alternative sources of finance. Building on its strong track record of lending and excellent arrears management, Riverside has secured social investment from Social Investment Business’s ‘Adventure Capital Fund’. This investment has enabled Riverside to make the transition from grant to loan funding and continue its ambitions for growth.

Development capital

To achieve sustainability by lending at scale, many of the community lenders we spoke to highlighted the importance of utilising efficient lending infrastructure to lower their operating costs. Addressing these issues can form a solid foundation for growth plans and help to ensure that customers are not being charged for inefficient systems.

As well as reducing their operating costs, organisations recognised the importance of investing in new and improved routes to market if they are to scale their operations and meet more of the demand for credit. Community lenders tend to be located on secondary real estate, have weak internet presence and minimal marketing spend. This makes it difficult for them to acquire the volume of customers required to enable them to scale their loan book and achieve efficiencies.

Though a number of the organisations surveyed have already made significant improvements to their infrastructure, they also recognise the need for continued development, particularly if they are to expand their operations through developing their online, mobile, telephone or high street presence. Of the total investment demand, about a third was linked to meeting development needs.

Regulatory capital

Discussions with DWP about the Credit Union Expansion Programme identified a further area where credit unions may require investment. Credit unions are bound by regulatory requirements governing their capital-to-total assets ratio. For organisations with fewer than 5,000 members and total assets below £5m, this ratio must be at least 3%. This ratio rises to 5% and then 8% as credit unions enter into higher bands of membership and assets. As credit unions grow, they may therefore need investment to help them meet this regulatory requirement[14].

[14] Bank of England (2013) *Letter to Directors* – July 12th. Available at: http://www.bankofengland.co.uk/pra/Documents/creditunions/Category%205%20credit%20unions%20meeting%20capital%20requirements.pdf, accessed 01/08/14, p.1.

London Mutual Credit Union (LMCU)

In early 2012, LMCU introduced a Payday loan product to help prevent its members from getting into difficulty with loans from high cost Payday lenders. To date, it has processed 10,700 loan applications totalling £2.8 million.

LMCU uses an automated system, supported by its team of experienced staff, to enable applications to be processed efficiently and cost effectively. Following the rise in the interest rate cap, LMCU now charges 42% APR for the loans. This enables the operating costs and loan losses to be covered.

In some cases, LMCU has granted larger long-term loans to help customers settle outstanding Payday loans with high cost lenders, some of which had increased to five times the original loan amount. Whilst the Payday loan product has helped to attract such customers to LMCU, it is expected that most of these members will move away from short-term borrowing and manage their finances by taking advantage of long-term, low cost loan products.

The role of social investment

Social ventures, like most businesses, need capital to grow. For community lenders, capital is required for three main purposes: onward lending, development costs and, in the case of credit unions, to meet regulatory requirements. Most of the community lenders that are seeking investment are limited by their short track record of sustainable delivery which poses risks and challenges for investors, making it very difficult for them to engage on purely commercial terms. This is contributing to a funding gap that threatens the ability of community lenders to grow at their desired pace.

Although a number of lenders are actively transitioning from a grant to investment-based model, there are variations in the speed at which organisations are making this change. These differences are often linked to the lender's wider plans for growth and therefore affect the amount and type of investment that they are seeking. Our analysis suggests that there is a range of ways that social investment could be deployed to meet demand and that the type of intervention required may vary according to the organisation's stage of growth.

For community lenders who are seeking investment to meet immediate needs and begin building a track record, the amount of capital required is relatively low, at less than £500k. This demand could be met through direct investment by individual social investors or through existing funds.

As organisations seek to further develop their business and enter a growth phase, they may benefit from technical assistance to support their development plans alongside larger amounts of capital, ranging from £0.5m - £5m. Existing funds are unlikely to be able to meet the need of these organisations for a combination of reasons including that they lack sufficient capital, are not established to meet long-term demand, are not structured to provide the combination of loan and development capital required and may not have the specialised expertise to inform investments.

Whilst existing funds are not designed to meet the specific demands of the community lending sector, they could play a valuable role through co-investing alongside investment from specialist funds. A wholesale social investment fund, led by a specialist fund manager could support organisations as they move from small-scale ad-hoc investments to accessing the larger, longer-term sources of capital required to support growth. Analysis of potential investors identified that social investment could support a fund of £10m-£25m.

Fair Finance

Since launching in 2005, Fair Finance has been working to tackling financial exclusion in London by offering a range of financial products including personal loans, business loans and debt advice. Through evidencing strong governance and building a five year record of transparent lending data, Fair Finance has been able to attract a range of investors.

Central to its approach has been the use of different tranches of funding, with social investment effectively providing a first loss position and being used to leverage senior debt from mainstream investors including Santander, BNP Paribas and Societe Generale. The investment from the banks was approved through their credit departments on commercial terms. To secure the investment there was a need to boost the gearing ratio of the portfolio and this required a further tranche of investment as a mezzanine between the first loss and senior debt.

This investment has enabled Fair Finance to lend almost £8m to 10,000 financially excluded residents. The organisation has now moved into profitability and is building on its fundraising experience and commercial relationships with key banking partners to further develop the financing structure required for its future expansion and growth.

To support transformational change within the community lending sector, the capital demands of community lenders who are further along their transition to sustainability and are seeking to significantly scale could be addressed. These organisations tend to be seeking investment in excess of £5m and have demonstrated some track record, though not enough to secure investment from purely commercial sources.

To help meet this demand, our research identified that social investment could be deployed as catalytic gearing capital either directly to the individual community lender, or at a fund level. Under such a model, social investment could be used to leverage in greater amounts of mainstream investment by de-risking the investment or taking a lower risk adjusted return. Either of these approaches would alter the risk reward profile, making it easier for mainstream investors to engage by providing senior debt on more commercial terms.

Within this model, social investment would be used as a form of credit enhancement to reduce risk to other investors. Stakeholders also suggested other ways that risk could be reduced for both mainstream and social investors. Given the relative lack of investment into community lenders and the growth process through which many of the organisations are progressing, fund managers making investments into the sector are likely to need to take a proactive approach to managing and supporting their portfolio. The fees that they charge may therefore be made up of a management component and a technical assistance cost. By splitting out these two types of fee it may be possible for grant finance to cover the technical assistance costs associated with business growth. This would reduce the overall management fees and protect investment returns.

Another area where it was suggested that grants can be effectively deployed is in relation to development costs. The ability of community lenders to deliver loans efficiently, with minimal write-offs has a major bearing on their financial model. By making improvements to their lending infrastructure, community lenders argued that they could drive efficiencies that have the potential to yield greater cost savings as lending operations are scaled up.

Although there is investment demand to cover development costs, it can be challenging for companies to achieve the returns required to cover these costs and repay loan capital. Grant finance could play a valuable role in helping organisations meet their development costs during their growth phase so that they can deliver the investor returns required to build up a track record and secure future investment. Housing associations, trusts and foundations have demonstrated a commitment to support community lenders in this way and there is the potential for this to be supplemented by pro-bono and low-bono support from corporate stakeholders.

Summary – looking ahead

This report explored three main hypotheses and has found them to be strong grounds for further examination by specialists with the expertise to develop fund models that can capture investor appetite.

Hypothesis 1 – Community lenders have limited access to the capital they require to scale: Current investment into community lenders has tended to be both small scale and piecemeal, failing to meet the capital requirements of organisations with ambitions to grow.

Hypothesis 2 – Community lenders have immediate demand for investment: There is demand for between £33m-£53m over the next two years, with approximately two thirds of this demand required for loan capital and the rest to support development plans.

Hypothesis 3 – Social investment can play a role in meeting some of this demand: There are a number of models that could be applied to enable social investment to be deployed to meet the capital needs of the sector. The case studies have illustrated ways in which these have already been successfully applied.

Our analysis identified a number of community lenders who are committed to building sustainable business models and see social investment as playing a vital role in helping them to meet their capital needs. These lenders report that social investment has the potential to help meet their capital demands at different stages in their growth. Existing sources of investment may be able to meet the needs of organisations at the earliest stages of growth plans. Addressing the lack of long-term capital available to community lenders seeking to scale up their operations and reach sustainability could help to deliver wider transformational change within the sector. Identifying the appropriate investment model and methods of risk mitigation is a familiar challenge to most SIFIs and those with a strong understanding of the community lending sector would be well placed to further explore and develop the propositions outlined in this report.

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